Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
1998 Biennial Regulatory Review --	)	CC Docket No. 98-137
Review of Depreciation Requirements	)	
for Incumbent Local Exchange Carriers	)	
	)	
United States Telephone Association's Petition	)	
for Forbearance from Depreciation Regulation	)	ASD 98-91
of Price Cap Local Exchange Carriers	)	

Reply Comments of BellSouth

BellSouth Corporation and BellSouth Telecommunications, Inc. ("BellSouth") hereby reply to the Comments made in response to the Notice of Proposed Rulemaking ("Notice"), FCC 98-170, and the United States Telephone Association ("USTA") Petition ("USTA's Petition") for Forbearance from Depreciation filed with the Federal Communications Commission ("Commission") released September 29, 1998, in the captioned proceeding.

I. Introduction

In its initial Comments, BellSouth demonstrated that the Commission should grant USTA's Petition and forbear from regulating depreciation for local exchange carriers ("LEC") subject to price cap regulation. When applied to price cap carriers, the current depreciation regulatory requirements are superfluous and ineffective. They greatly increase the cost and burden of compliance with no measurable improvement in customer protection.

Predictably, the two most vocal opponents of regulatory forbearance are AT&T and MCI WorldCom.[1] As interexchange carriers ("IXC"), not only can they currently compete against LECs in the local exchange market, but also will face direct competition from LECs once the LECs receive authorization to provide interLATA services pursuant to Section 271 of the Telecommunications Act of 1996 ("1996 Act"). Accordingly, the competitive interests of these IXCs lie in ensuring that the LECs retain costly and burdensome regulation that is not imposed upon the IXCs.

Neither IXC provides any convincing reasons to support its opposition to forbearance of depreciation regulation now borne only by the LECs. Each simply parrots back the list of situations that the Notice suggested depreciation continues to affect.[2] BellSouth explained in its comments, however, that these situations provide no grounds to continue the current regulatory scheme. Continued regulation of depreciation for only the LECs is of no benefit under price cap regulation. The IXCs' Comments represent self-serving, anticompetitive opportunism that, if continued, would harm the public interest.

[1] AT&T and MCI WorldCom presented virtually identical Comments. Indeed several sections contained the exact words. Because the comments are identical, in order to avoid redundant references to both the AT&T and MCI WorldCom Comments, BellSouth will refer only to the AT&T Comments.

[2] Interestingly, AT&T now opposes the forbearance of depreciation regulation for a carrier subject to price cap regulation when only five years ago it was arguing for virtually the same treatment. AT&T does not even acknowledge its change in position, much less justify it. In comments filed In the Matter of Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, AT&T did argue against LECs receiving forbearance. It did so, however, on the basis of sharing and the low-end adjustment. Sharing has since been eliminated and, as explained in BellSouth's and other LEC comments, the low-end adjustment is an insufficient reason for continuing depreciation regulation.

II. None of the Opposing Comments Presented a Credible Reason to Deny Regulatory Forbearance.

A. Competition in the Local Exchange Market.

AT&T argues that competition does not exist in the local markets. Its comments conclude that the lack of competition requires the continuation of depreciation regulation because "substantial market power ... gives [the ILECs] the ability to manipulate depreciation expense for anticompetitive purposes." As an example of this ability AT&T states "depreciation factors could be adjusted to increase the ILEC-calculated 'costs' of bottleneck network components that ILEC competitors require, while simultaneously reducing the 'costs' of other network elements that underlie the ILECs' competitive services but are not used by competitors."[3] AT&T's conclusion, and basis for its conclusion, is wrong for three reasons.

First, the pricing of network elements is a matter for state public service commissions ("PSC").[4] The continued argument that the Commission must regulate interstate depreciation expense in order to ensure that network elements are properly priced completely ignores the current allocation between state and federal regulators of responsibility and authority established by the 1996 Act and interpreted by a federal court. Therefore, the Commission's regulation of depreciation will have no impact on the pricing of network elements whether competition exists or not.

Second, price cap regulation is an adequate surrogate for competition. As the SBC LECs stated in their comments "by replicating a competitive environment, price cap regulation imposes a sufficient constraint on a price cap ILEC's pricing such that it is not reasonably necessary to

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[3] AT&T Comments at 13.

[4] *See* Iowa Utilities Board v. FCC, 120 F.3d 753 (8th Cir. 1997), *cert. granted*, 118 S.Ct. 879 (U.S. Jan. 26, 1998) (Nos. 97-826, 97-829, 97-830, 97-831, 97-1075, 97-1087, 97-1099, 97-1141).

regulate depreciation rates directly, especially now that sharing has been eliminated."[5] This point was further explained in the affidavit of William E. Taylor and Aniruddha Banerjee included as Attachment A to the USTA comments ("Taylor Affidavit"). It explains that:

> The inability to transmit changes in cost (whether or not triggered by changes in depreciation rates) into prices of services subject to price cap regulation offers the best possible protection for consumers. While prices of those services are capped formulaically by the rate of inflation and a productivity offset factor, prices of the ILEC's *competitive* services are subject to the checks and balances that exist in a competitive market. Therefore, the *degree* of competition itself for services subject to price cap regulation matters only for determining when services currently under price caps should be transitioned to the category of competitive services (i.e., out of price caps). The degree of competition does *not* determine whether forbearance from depreciation prescription affects the prices of price-capped services one way or the other.[6]

Third, competition exists in the local market and is continuously increasing.[7] Thus, even if one rejects the fact that price cap regulation obviates the need for competition to protect consumers from the effects of potential excessive depreciation expense, the current and increasing competition should not, and indeed cannot be ignored. Accordingly, the Commission should forbear from depreciation regulation.

B. Situations Identified in the Notice Do Not Warrant Continued Depreciation Regulation for Price Cap LECs.

In the Notice, the Commission identified several situations for which it suggested continued regulation of depreciation was necessary. As expected, AT&T agrees with the Commission's contention regarding these situations. The reasons provided by AT&T to support the Commission's statements, however, are refuted by BellSouth and other LECs. BellSouth sees no reason to belabor the points made in those comments and directs the Commission's

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[5] SBC LECs' Comments at 26.

[6] Taylor Affidavit at 9-10, emphasis in original.

[7] *See* SBC LECs' Comments at 26 and Exhibit A to the SBC LECs' Comments.

attention to its and other LECs' earlier comments, which demonstrate that these situations do not justify the continued burdensome depreciation regulation.

AT&T does assert one argument, however, to which BellSouth provides a specific response. AT&T argues that depreciation regulation should continue for low-end adjustment purposes because the LECs' earnings are currently too high. AT&T claims that the higher earnings are the result of the productivity factor in the price cap formula being set too low in the past. AT&T further claims that the Commission should raise the productivity factor for price cap LECs, and if raised, LECs' earnings will drop thus promoting more low-end adjustments. This argument is typical of the self-serving rhetoric usually espoused by AT&T.

First, AT&T's circular argument is completely irrational. Price cap regulation was not designed to push LECs' earnings so low that they must seek low-end adjustments. To suggest that productivity factors should be raised to such an extent that LECs' earnings would be pushed at or below the low-end adjustment level only reveals AT&T's anti-LEC position.

Second, there is evidence on the record that demonstrates that the productivity factors are not too low, but are in fact too high. In the Access Reform[8] docket USTA filed comments that updated the Commission's X-Factor model for the 1996-97 period.[9] The updated results indicate, using the Commission's own model, that the X-Factor for 1996 was 2.1% and 4.1% for 1997. This evidence confirms that the 6.5% X-Factor set in 1997 was too high. Accordingly, the Commission should reject AT&T's fallacious claims.

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[8] In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing and End User Common Line Charges, CC Docket Nos. 96-262, 94-1, 91-213 and 95-72, *First Report and Order*, 12 FCC Rcd 15982 (1997), and Price Cap Performance Review for Local Exchange Carriers and Access Charge Reform, CC Docket Nos. 94-1 and 96-262, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, 12 FCC Rcd 16642 (1997) ("Access Reform").

[9] Attachment D to USTA Comments filed on October 26, 1998, in Access Reform docket.

C. 1996 Act Allows Depreciation Forbearance

AT&T claims that Section 220(b) was not amended by the 1996 Act "so that the Commission could deregulate the depreciation practices of price cap carriers." AT&T contends that the "intent of [the amendment] ... was to recognize that the Commission needs to focus its attention on the larger ILECs, and not, as USTA would have it, to deregulate the depreciation practices of these same larger ILECs."[10] AT&T cites a Commission report to support this contention. AT&T's statements are completely misguided.

The plain language of the statute requires no elucidation. It states that "the Commission *may* prescribe [depreciation charges] for such carriers as it determines to be appropriate ...."[11] The change clearly gives the Commission discretion to forbear from all depreciation regulation. AT&T's attempt to reduce the amendment to nothing more than a minor statutory adjustment to allow the Commission to continue the status quo is nonsensical.

The absurdity of AT&T's position is even more fully revealed when the authority for its position is examined. AT&T cites a 1995 report to the Commissioners by a Special Counsel to the Commission on Reinventing Government.[12] The Report included an appendix that stated several recommendations for legislative change. The recommendation referred to by AT&T states:

> Repeal Setting of Depreciation Rates. (Sec. 220(b)) Repeal mandatory FCC setting of depreciation rates for common carriers. This would give the FCC

[10] AT&T Comments at 14.

[11] 47 U.S.C. § 220(b)(Supp. 1997).

[12] Creating a Federal Communications Commission for the Information Age, Report of the Special Counsel to the Commission on reinventing Government, February 1, 1995. This report is not even a part of legislative history of the Telecom Act of 1996, and cannot be used to determine the intent of Congress in passing that legislation. Nevertheless, as demonstrated in the next paragraph of text, even the report it cites does not support AT&T's position.

greater flexibility if it determined that setting depreciation rates for some or *all* telecommunications carriers no longer serves the public interest.[13]

The recommendation plainly states that the change would allow the Commission greater flexibility should it determine that depreciation regulation for all carriers, not just the small LECs, is no longer in the public interest. AT&T's claims, therefore, are completely without merit.

D. AT&T Does Not Understand Generally Accepted Accounting Principles ("GAAP")

AT&T argues that GAAP accounting is inappropriate for regulatory purposes. It states that "GAAP is governed by the 'conservatism' principle, which favors the understatement (versus overstatement) of net income and net assets where any potential measurement problems exist. Such a measurement bias in a regulated industry, however, would lead to the establishment of excessively high depreciation rates, with consequent harm to the public."[14] Such an argument reveals a lack of understanding of GAAP. Arthur Andersen prepared a comprehensive white paper which was filed with the Commission on July 15, 1998,[15] and a supplement to that white paper, filed on November 10, 1998.[16] That white paper analyzed the existing accounting cost allocation and affiliate transaction rules. The Andersen Supplement addressed the very issue raised by AT&T regarding GAAP. In response to the accusation that GAAP was ineffective in a regulatory setting, Andersen stated:

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[13] *Id.* at Appendix A, item 2, (emphasis added).

[14] AT&T Comments at 21.

[15] *Ex Parte* filed July 15, 1998, "Accounting Simplification in the Telecommunications Industry," prepared by Arthur Andersen LLP ("Arthur Andersen Report" or "Report").

[16] *Ex Parte* filed November 10, 1998, "Supplement to July 15, 1998 Position Paper 'Accounting Simplification in the Telecommunications Industry,'" prepared by Arthur Andersen LLP ("Andersen Supplement").

> The implication here is that conservative accounting principles would be the rule under GAAP, thus leading to understatements of net income and corresponding overstatements of costs and associated rates charged to ratepayers.
>
> [This] interpretation of GAAP is misguided. The purpose of GAAP is to guard against material misstatements, including overstatements as well as understatements, in the financial statements. Financial statements prepared in accordance with GAAP are intended to present **fairly**, in all material respects, the financial position, results of operations and cash flows of the company. This "presents fairly" concept covers both the understatement and overstatement of financial results. Thus, both shareholders and ratepayers are protected via the effective application of GAAP. If GAAP were purely based on conservatism ... then the auditors' report would state that the financial statements present conservatively, not fairly, the company's financial results.
>
> [This view of GAAP] also ignores the reality of today's economic environment .... All companies, including the ILECs, face significant expectations by the investment community to meet or exceed earnings and earnings per share targets. To the extent that earnings fall below analyst expectations, the company's stock price and its ability to attract additional capital suffers. [The] assertion that conservative accounting would be applied in all cases in order to produce excessive regulated rates is ludicrous.[17]

AT&T's misunderstanding of GAAP should not be seen as a hindrance to forbearance of depreciation.

E. The Commission Should Wait on Making Any Changes to Salvage Value and Cost of Removal.

The comments regarding whether to implement the suggested changes to salvage value and cost of removal were mixed. Obviously, the solution to the entire matter is for the Commission to forbear from regulation, which would obviate the need for any further discussion. If the Commission fails to forbear, BellSouth reiterates that any change to the treatment of salvage value and cost of removal at this point in time would be premature. The Commission should defer any changes until the issue is resolved by the Financial Accounting Standards Board. To change the process now will certainly lead to confusion and may possibly add one

[17] Andersen Supplement at 11, emphasis in original.

more item for which reconciliation between the regulatory and GAAP books must occur. Accordingly, short of complete forbearance, the prudent course for the Commission to take is wait and not make any change to salvage value or cost of removal.

V. CONCLUSION

Based on the forgoing, the Commission should abandon its Notice of proposed changes to depreciation regulation and adopt the Petition for Forbearance submitted by USTA.

Respectfully submitted,

BELLSOUTH CORPORATION AND
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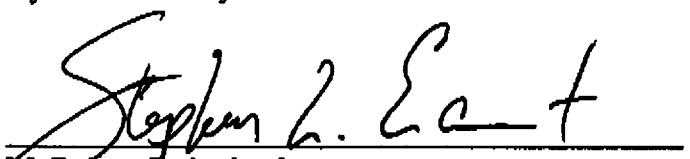
By their Attorneys



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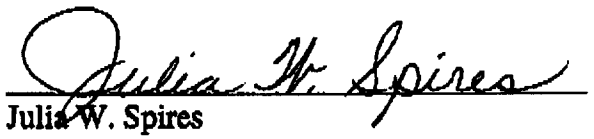
Date: December 8, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have this 8th day of December1998, serviced all parties to this action with the foregoing *Reply Comments of BellSouth*, reference CC Docket No. 98-137, ASD 98-91 by hand service or by placing a true and correct copy of the same in the United States Mail, postage prepaid, addressed to the parties as set forth on the attached service list.



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